IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF TENNESSEE
GREENEVILLE DIVISION

UNAKA COMPANY, INCORPORATED~~, et al.~~,	)
Plaintiffs,	)
v.	) CIVIL ACTION NO.
GORDON H. NEWMAN and JERALD K. JAYNES,	) 2:99-CV-267
Defendants.	)
GORDON H. NEWMAN and JERALD K. JAYNES,	)
Counter-Plaintiffs,	)
v.	)
UNAKA COMPANY, INCORPORATED, et al.,	)
Counter/Third-Party Defendants.	)

BRIEF OF THE SECRETARY OF LABOR AS AMICUS CURIAE

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THE INTEREST OF THE SECRETARY

The Secretary is the federal officer charged with interpreting and enforcing the provisions of ERISA involved in this action. As such, the Secretary has significant interests in the proper application of the safeguards Congress established through ERISA for the administration of employee benefits plans and the protection of participants in those plans. These interests include promoting uniformity of law, protecting beneficiaries, enforcing fiduciary standards, and ensuring the financial stability of employee benefit plan assets. Secretary of Labor v. Fitzsimmons, 805 F.2d 682 (7th Cir. 1986) (en banc). The Secretary has a particular interest in this case because it concerns the interpretation and legal effect of an administrative prohibited transaction exemption issued by the Secretary pursuant to ERISA section 408(a), 29 U.S.C. § 1108(a), and the implementing regulations promulgated by the Secretary, 29 C.F.R. § 2570.30, et seq.

INTRODUCTION

This case involves a complex transaction that occurred on June 13, 2000, between Unaka Co., Inc. Profit Sharing Plan and Trust (the "Plan") and Unaka Co., Inc. In that transaction, the Plan assigned to Unaka the Plan's claims against certain Plan fiduciaries arising from their failure to consummate a proposed sale of the Plan's 14,000 shares of Unaka stock for $413 a share in 1996 and transferred those shares to Unaka. In exchange, Unaka gave the Plan a $5.6 million no interest, non-recourse loan and $13 per share ($182,000) for the stock.

ERISA section 406(a), 29 U.S.C. § 1106(a), prohibits certain transactions between an ERISA-covered plan and related parties ("parties in interest") unless those transactions qualify for an exemption under ERISA section 408, 29 U.S.C. § 1108. Congress treated such transactions as "per se" violations because they present a "high potential for loss of plan assets or insider abuse." Chao v. Hall Holding Co., Inc., 285

F.3d 415, 439 (6th Cir. 2002), cert. denied 537 U.S. 1168 (2003), quoting Reich v. Valley Nat'l Bank of Arizona, 837 F. Supp. 1259, 1281 (S.D.N.Y. 1993). In this case, the Plan's sale of its Unaka stock to Unaka, the assignment of the Plan's fiduciary breach claims to Unaka, and the loan from Unaka to the Plan and related transactions were prohibited by ERISA sections 406(a)(1)(A) and (D), 29 U.S.C. §§ 1106(a)(1)(A) and (D), because Unaka was a party in interest to the Plan under ERISA section 3(14), 29 U.S.C. § 1002(14).

A transaction can be exempt from the prohibited transaction provisions if: (1) it meets the terms and conditions of an administrative exemption granted by the Secretary under ERISA section 408(a), 29 U.S.C. § 1108(a), that specifically covers that transaction; or (2) it meets the requirements of a statutory exemption under ERISA sections 408(b)-(f), 29 U.S.C. §§ 1108(b)-(f). In either case, it is well established that the parties who engage in the transaction have the burden of proving that the transaction is exempt under section 408, that is, that it meets the terms and conditions of an administrative exemption or the criteria for a statutory exemption. Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996), cert. denied, 520 U.S. 1237 (1997); Lowen v. Tower Asset Mgmt., Inc., 829 F.2d 1209, 1215 (2d Cir. 1987); Donovan v. Cunningham, 716 F.2d 1455, 1467-68 n.27 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984); Marshall v. Snyder, 572 F.2d 894, 900 (2d Cir. 1978).

In this case, the Secretary issued an administrative exemption, PTE 99-31, 64 Fed. Reg. 40,627 (July 27, 1999). That exemption did not designate the sale of the stock as a transaction covered by the exemption. The exemption did designate the assignment of the fiduciary breach claims, the loan, and other provisions of the transaction as covered and imposed fourteen conditions on availability of the exemption. These conditions were not findings of fact by the Secretary. Rather, they were requirements that the parties had to satisfy before they could rely on the exemption. If Unaka now wants to assert that the exemption covers its conduct, it must first prove that it satisfied the conditions. The Department did not adjudicate the question of whether the parties, in fact, satisfied the terms of the exemption, nor does it make such factual determinations in the process of issuing exemptions.

The sale of the stock may potentially qualify as exempt under ERISA section 408(e), 29 U.S.C. § 1108(e). That provision exempts the Plan's sale of Unaka stock to Unaka if the sale was for "adequate consideration." Under ERISA, "adequate consideration" in this context means the "fair market value of the asset as determined in good faith by the trustee," 29 U.S.C. § 1002(18)(B). Once again, the burden is on the parties who engaged in the transaction to establish that the sale was for adequate consideration. Howard v. Shay, 100 F.3d at 1488. The Secretary specifically stated in PTE 99-31 that she expressed no opinion as to whether the sale met the requirements of section 408(e). 64 Fed. Reg. at 40,627 n.2.

ARGUMENT

I. The Prohibited Transaction Exemption Issued By The Secretary Did Not Exempt The Sale Of The Stock

On December 31, 2003, this Court issued an order vacating a prior order in the case granting summary judgment to the Defendants. In part, this Court issued the order based on its conclusion that the exemption that the Secretary of Labor granted the Plaintiffs explicitly or implicitly concluded that the sale of stock from the Plan to Unaka was for fair market value and thus exempt from the prohibition in ERISA section 406(a)(1). The Plan's sale of the Unaka stock to Unaka could be exempt from the prohibited transaction provisions of ERISA section 406(a), 29 U.S.C. § 1106(a), if the Secretary granted an administrative exemption under ERISA section 408(a), 29 U.S.C. § 1108(a), or if it met the requirements of the statutory exemption in ERISA section 408(e), 29 U.S.C. § 1108(e). As explained below, the Secretary did not grant an administrative exemption for the sale and expressed no opinion as to whether the sale qualified for the section 408(e) statutory exemption.

In applying for an administrative exemption for the loan from Unaka to the Plan and the assignment of the claims from the Plan to Unaka, the company specifically stated that it was not asking for an administrative exemption for the sale of the stock and represented that the sale was exempt under ERISA section 408(e), 29 U.S.C. § 1108(e):

> The purchase of the Plan Shares from the Plan by Unaka is a transaction covered by the exemption provided under ERISA section 408(e) and is, therefore, <u>not the subject of any requested relief under this submission</u>.

<u>See</u> Brief of Defendants/Counter Plaintiffs Concerning Issues Raised by the Court's September 11, 2003 Order, Tab 53 at UNJO18674 (Letter from Riva T. Johnson to Angelena LeBlanc, dated March 1, 1999, page 4) (emphasis added).

Not surprisingly, therefore, the administrative prohibited transaction exemption granted by the Secretary, PTE 99-31, 64 Fed. Reg. 40,627 (July 27, 1999), did not provide relief for the sale of the Unaka stock under ERISA section 408(a), and it expressed no opinion as to whether the sale was exempt under ERISA section 408(e). The exemption listed the transactions subject to the exemption as: (a) the assignment of the Plan's fiduciary breach claims to Unaka; (b) the interest-free, non-recourse loan from Unaka to the Plan; (c) the possible repayment of that loan from any recovery on the fiduciary breach claims; (d) the interest-free, non-recourse extension of credit by Unaka to the Plan of certain expenses in the fiduciary breach claims; and (e) the possible reimbursement of Unaka for those expenses from the recovery on the fiduciary breach claims. 64 Fed. Reg. at 40,627. Significantly, the exemption does not list the sale of Unaka stock.

Because the loan and assignment and sale were all part of a complex transaction, the exemption refers to the sale of the stock but expressly declines to exempt it. In describing the loan to the Plan as a transaction subject to the exemption, the Secretary stated that the loan was:

> in an amount equal to the difference between $413 and the fair market value per share for the common stock of Unaka (the Stock) held by the Plan, <u>in connection with the sale of such Stock by the Plan to Unaka, pursuant to the statutory exemption, as set forth in section 408(e) of the Act.</u>

64 Fed. Reg. at 40,627 (emphasis added). The footnote following this statement clarified that the reference to the sale being exempt under section 408(e) was based on Unaka's representation in its application that the sale was exempt under that provision, and was not based on the Secretary's view as to whether it qualified for that statutory exemption:

> The Department, herein, expresses no opinion as to the applicability of the statutory exemption provided by section 408(e) of the Act to the sale by the Plan of its Unaka Stock to Unaka or as to whether the conditions set forth in such statutory exemption are satisfied in the execution of such transaction.

<u>Id</u>. at 40627 n.2. Had the Secretary intended her administrative exemption to cover the sale, this footnote would have been unnecessary because whether it was exempt under section 408(e) would have been immaterial. Moreover, still referring to the sale, the footnote reiterated that the administrative exemption only covered the transactions enumerated in the exemption:

> Further, the Department, herein, is offering no relief for transactions other than the transactions described in this exemption.

<u>Id</u>. Given this statement of the limited nature of the exemption, and the footnote's statement concerning the statutory exemption under section 408(e), the footnote confirms what the text of the exemption provides: the sale of the stock was not covered by the exemption.

II. The Secretary Did Not Make A Determination That The Conditions The Secretary Imposed On The Exemption Had Been Met

Under ERISA section 408(a), 29 U.S.C. § 1108(a), the Secretary may grant either a "conditional" or an "unconditional exemption." The Secretary's regulations state that a conditional exemption is "effective . . . only under the conditions set forth in the exemption," that is, the exemption is of no effect if all the conditions are not met. 29 C.F.R. § 2570.49(b). In granting the exemption, the Secretary does not make findings as to whether the requisite conditions in fact exist or will exist in the future when the subject transaction occurs.

The exemption in this case is a conditional exemption. PTE 99-31 granted relief for the loan and the assignment "provided that the following conditions are satisfied" and listed fourteen separate conditions. 64 Fed. Reg. at 40627. Conditions six and nine were as follows:

> (6) The transactions which are the subject of this exemption do not involve any risk of loss either to the Plan or to any of the participants and beneficiaries of the Plan. . . .
>
> (9) All of the terms of the transactions are at least as favorable to the Plan as those which the Plan could obtain in similar transactions negotiated at arm's length with unrelated third parties.

Id.

This Court stated that the Secretary "found" that these conditions in fact existed. Order at 9. These were not findings by the Secretary. Rather, they were conditions imposed on the granting of the exemption. As with any conditional exemption, those who seek to engage in the transaction covered by the exemption must ensure that the enumerated conditions have been met. If, as here, the transaction is challenged, the Court must ultimately determine whether the conditions were met and, therefore, whether the exemption is effective.

The only factual findings made by the Secretary in PTE 99-31 were those the statute requires as a predicate to granting an exemption:

> The Secretary may not grant an exemption unless [s]he finds that such exemption is:
>
> (1) administratively feasible,
>
> (2) in the interests of the plan and of its participants and beneficiaries, and
>
> (3) protective of the rights of participants and beneficiaries of such plan.

ERISA section 408(a), 29 U.S.C. § 1108(a); see PTE 99-31, 64 Fed. Reg. at 40626. These findings, however, were conditioned on the satisfaction of the fourteen conditions listed in the exemption. Moreover, the three statutory findings pertained only to the transactions covered by the exemption. By its terms, the exemption did not extend to the sale of Unaka stock or to any transactions for which the parties failed to meet the conditions set forth in the exemption text.

III. Under Chao v. Hall Holding Adequate Consideration For Closely Held Stock Must Be Based On A Fiduciary's Good Faith Investigation Into The Fair Market Value Of The Stock

This Court determined that it could not conclude as a matter of law that a prudent trustee would not have engaged in the transaction since the non-recourse loan deal effectively gave the Plan $413.00 per share. Op. at 9. In so holding, the Court quoted language from the Sixth Circuit's decision in Chao v. Hall Holding Co., Inc., 285 F.3d at 435:

> Even if a trustee fails to make a good faith effort to determine the fair market value of the stock, "he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway." Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 919 (8th Cir. 1994). Thus, if a prudent trustee would

> have purchased the Lenco stock for the price for which Mueller purchased it, then Mueller did not violate ERISA, regardless of whether he made a good faith effort to determine the fair market value of the stock.

Order at 8-9. The court in Hall Holding did not, however, adopt the standard described in the quoted language. Indeed, the quote itself is actually from the Eighth Circuit's holding in Herman v. Mercantile Bank, N.A., 143 F.3d 419, 421 (8th Cir. 1998), which the court in Hall Holding specifically rejected. 285 F.3d at 436.

Instead, the court in Hall Holding agreed with the position adopted by the dissent in Mercantile Bank. See Hall Holding, 285 F.3d at 436 (finding that "the position announced by the dissenting opinion in Mercantile Bank is much more persuasive"). In adopting this standard, the court in Hall Holding reasoned that while ERISA section 406(a)(1), 29 U.S.C. § 1106(a)(1), prohibits plan purchases of stock from an employer, ERISA section 408(e) exempts such purchases if they are for "adequate consideration," 29 U.S.C. § 1108(e). 285 F.3d at 436. Because ERISA elsewhere defines "adequate consideration" for closely held corporations as the "fair market value of the asset as determined in good faith by the trustee," 29 U.S.C. § 1002(18)(B), any person claiming the section 408(e) exemption must not only establish that the stock reflects the fair market value, but must also establish that the fiduciary conducted a good faith determination to establish the value. 285 F.3d at 436. Thus, contrary to the hypothetical prudent fiduciary rule adopted by the majority in Mercantile Bank, which would absolve fiduciaries of liability if they blindly happen upon the right price, the rule of Hall Holding correctly recognizes that fiduciaries necessarily breach their duties where they fail to properly investigate the fair market value of the employer stock. Id. at 436-37. Such a breach, however, would not cause a monetary loss to the plan where the plan pays the right price.

Accordingly, while determining whether the Plan was in fact harmed by the transactions is essential in fashioning a remedy, see Section IV, infra, it is in fact irrelevant to determining whether the fiduciaries here met the adequate consideration exemption with regard to the sale of Unaka stock.

IV. The Court Is Not Required To Undo The Transactions Even If It Finds That A Prohibited Transaction Occurred

The Secretary files this brief in order to explain the legal effect of her exemption and to state the appropriate test of fiduciary liability under the Sixth Circuit's decision in Chao v. Hall Holding Co., Inc. and does not otherwise address the merits of the respective positions taken by the parties. However, the Secretary also would like to stress that the Court is not required to undo the transactions, which may well have been beneficial to the plan, if it determines that any of the parties engaged in prohibited transactions. Instead, under ERISA section 502(a)(3), 29 U.S.C. § 1132(a)(3), the Court's charge is to fashion "appropriate equitable relief," which is best designed to protect the interests of the plan participants and beneficiaries under the circumstances. See Varity Corp. v. Howe, 516 U.S. 489, 515 (1996) ("We should expect that courts, in fashioning 'appropriate' equitable relief, will keep in mind the 'special nature and purpose of employee benefit plans'"); see also Nieto v. Ecker, 845 F.2d 868, 874 (9th Cir. 1988) (noting that "if plaintiffs prevail on the merits, they will be entitled to whatever equitable relief -- including the issuance of an injunction or the imposition of a constructive trust upon property improperly received . . . as the district court may deem appropriate").

The Defendants have suggested a number of possible remedies including: (1) recalculating the price of the stock based on the difference between the price received and the fair price based on the exercise of the Plan's dissenter rights, or the actual fair market value less the price received as of the date of the transaction; (2) reformation of the promissory note so that if the fair market value of the stock is increased, any repayment obligation from the Plan to Unaka from the litigation recovery must be correspondingly reduced; and (3) if reformation is not possible, recission of the assignment and loan. If the transactions are rescinded, it appears obvious that the Plan would be harmed – it would have to return an aggregate amount of $5.7 million in cash, lose the future investment income from the money, and be left with an illiquid asset of diminishing value. In addition, the company argues that rescission of the Assignment and Loan would require the Plan to reimburse the Company for its litigation expenses. Because all of this would harm the Plan, rescission is not "appropriate" equitable relief under ERISA section 502(a)(3) to remedy prohibited transactions, and should be rejected by this Court. With regard to the other two proposed remedies (and any other possible remedy), the Secretary urges that this Court adopt the most beneficial remedy to the Plan if Defendants Newman and Jaynes are successful on the merits of their suit.

CONCLUSION

For all the above reasons, the Secretary requests that the Court issue an order on reconsideration reflecting the true nature of the exemption granted by the Secretary and setting forth the appropriate test of fiduciary liability as stated in the Sixth Circuit's decision in the Hall Holding case.

Dated: January 29, 2004

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on January 29, 2004, I caused a copy of the foregoing SECRETARY OF LABOR'S BRIEF AS AMICUS CURIAE to be served by United States mail, first-class postage thereon fully prepaid, addressed as follows:

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